F. INSURANCE ACTIVITIES OF EXEMPT ORGANIZATIONS

1. Introduction

The purpose of this topic is to update previous ATRI (1979, p. 338) and CPE (1981, p. 272) discussions of insurance activities carried on by exempt organizations. The topic will focus on recent developments in the area of group insurance for members (UBI). It will also consider certain exemption issues under IRC 501(c)(6) and the use of voluntary employee beneficiary associations (IRC 501(c)(9)) to provide insurance benefits to members of an IRC 501(c)(6) organization.

2. Group Insurance Activities

A. Unrelated Business Income

In past years, we have examined various arrangements whereby an exempt organization (in most cases an IRC 501(c)(5) or IRC 501(c)(6) organization) acts as a group insurance policyholder for its members. In addition to serving as the group policyholder, the exempt organization agrees to perform assorted administrative duties in connection with the insurance program. The income to the organization may be in the form of fees from the insurance company for insurance promotion, a percentage of the premiums collected, or experience rating reserve refunds. As noted in the 1981 CPE text, the Service has consistently taken the position that, whatever the actual extent of an exempt organization's activities under these arrangements, the income derived from the insurance relationship meets the three basic requirements for taxation under IRC 511-513 as income from unrelated trade or business, i.e., it is income from (1) trade or business, which is (2) regularly carried on, and (3) unrelated to the exempt organization's exempt purpose.

(1) Trade or Business

Whether the group insurance activities constitute a "trade or business" within the meaning of IRC 513(c) was first raised in the grandfather case in this area, Oklahoma Cattlemen's Association, Inc. v. U.S., 310, F. Supp. 320 (W.D. Okla. 1969). (Our disagreement with this District Court decision is discussed in detail in the 1979 ATRI.) Three recent appellate cases, decided in favor of the Service, support the view that in determining whether a trade or business exists the

decisive factor is whether the activity is profit motivated, not whether it is "active or passive," or whether it is directly competitive with commercial enterprises.

In Professional Insurance Agents of Michigan v. Commissioner, 726 F.2d 1097 (6th Cir. 1984) (hereinafter, PIA), the Sixth Circuit affirmed the Tax Court's ruling that administrative and promotional fees and an experience rating reserve refund constituted income from unrelated trade or business to an organization described in IRC 501(c)(6). This conclusion was founded, in part, on the court's analysis that the presence or absence of a profit motive was the determinative factor in the "trade or business" inquiry under IRC 513(c):

> The language of the statute states that any activity which is carried on for the production of income is to be deemed a trade or business. IRC Section 513(c). The phrase "carried on for the production of income" limits the type of activities covered. That phrase requires us to examine the exempt organization's underlying reasons for engaging in the questioned activity. If it has as its motive the production of income, the activity constitutes a trade or business under section 513(c), so the language of the Code prescribes the application of the motive test. The regulations under section 513 strengthen this interpretation of the statute by incorporating the section 162 meaning of the term trade or business.

Focusing on its role in selecting insurance carriers and negotiating fees with them and its role in promoting and administering the insurance products, the Sixth Circuit found the record supported the Tax Court's finding that a profit motive was reflected in the appellant's activities,

Similar conclusions were reached by the Fourth and Fifth Circuits in Carolina Farm & Power Equipment Dealers Ass'n v. United States, 699 F.2d 167 (4th Cir., 1983) (Carolinas Farm) and Louisiana Credit Union League v. United States, 693 F.2d 525 (5th Cir., 1982) (LCUL). In LCUL, the court expressly adopted the "profit motive" standard before ruling the record supported the district court's finding of profit motive. As in PIA, the court focused on the business league's selection of carriers and its endorsement, promotion, and administration of the insurance policies. In Carolinas Farm, the Fourth Circuit reversed the District Court's judgment in favor of an IRC 501(c)(6) organization and ruled that a finding of profit motive was sufficient to satisfy the "trade or business" requirement of IRC 513(c) and that the only inference to be drawn from the record was that a profit motive was present. The Fourth Circuit supported this conclusion by relying on the consistent profitability of the insurance program, the high proportion of insurance

income to total income, and the absence of a causal connection between the insurance activity and accomplishment of the organization's exempt purposes.

(2) Regularly Carried On

The existence of this component of unrelated trade or business has not been seriously contested in recent years. It is generally acknowledged that the group insurance activities are ongoing and continuous.

(3) Relationship to Exempt Purposes

The 1981 CPE text states the Service position that group insurance activities are not, in most cases, substantially related to exempt purposes other than through the production of income. The 4th, 5th, and 6th Circuit Court decisions cited above clearly adopt the Service's nonrelated position. The group insurance activities serve the interests of members in their individual capacity by making insurance available to them at an economical rate. The group insurance does not generally benefit the members in their capacity as members of the organization. In other words, the insurance is strictly a quid pro quo proposition with a member receiving a benefit exactly proportional to the premium paid.

Whether an activity is related to the accomplishment of any purpose for which an organization is recognized as exempt, however, depends in each case on the facts and circumstances involved. In GCM 39296, (June 20, 1984), the Service considered group insurance programs conducted by two organizations whose members are comprised of county governments. Both organizations are exempt as social welfare organizations described in IRC 501(c)(4). Organization A has, as one of its stated purposes, the improvement of county governments by making them more efficient. The organization's stated purpose in engaging in insurance activities is the provision of coverage to its members at a more economical rate than would otherwise be available. The stated purposes of organization B include: fostering cooperation among counties and other governmental bodies for the advancement of the joint and several interests and general welfare of its members; collecting, studying, and disseminating information and materials which will encourage improved county government; conducting research and studies useful to county government; and providing training and education to county officials. The GCM concludes that under these circumstances the insurance activities of each organization serve the charitable purpose of lessening the burdens of government and, therefore, necessarily promote social welfare. Accordingly, the insurance

activities are substantially related to the accomplishment of the organizations' exempt purposes and do not constitute unrelated trade or business.

GCM 39296 represents an atypical situation and should be limited to its facts. (As with all released GCMs, it is not citable authority in any event, but may be useful as a source of legal analysis.) Most organizations, as stated above, will be unable to establish that the provision of insurance to members is related to their exempt purposes.

B. Section 170 Issues

Certain charitable contribution issues emerge if an IRC 501(c)(3) organization serves as the group insurance policyholder for its members. As a condition for enrollment in the group policy, the insured member must oftentimes assign to the IRC 501(c)(3) organization his or her rights to any experience credits or rebates received from the insurer. Some individuals have claimed a charitable contribution deduction for that portion of the credits or rebates attributable to their participation in the insurance program. As explained in the 1981 CPE text at page 279, the Service has held these amounts are not deductible under IRC 170 because they are not paid voluntarily, but rather are a prerequisite for obtaining insurance. Further, the individuals have been unable to establish that the premium payments for the insurance exceed the fair market value of the benefits received. (See American Bar Endowment, discussed below.)

C. American Bar Endowment

A significant group insurance case currently in litigation involves the American Bar Endowment.

(1) Facts

The American Bar Endowment (ABE or Endowment) is exempt from tax under IRC 501(c)(3). While all members of the American Bar Association (ABA) are automatically members of the Endowment, the Endowment is a separate legal entity.

ABE's primary stated purpose is to promote charitable and educational research in the field of law by making grants to organizations that conduct such research in that field. Beginning in 1955, the Endowment raised funds for its grantmaking program by sponsoring and administering group insurance policies.

Initially, only small amounts of life insurance were available, but over the years, greater amounts and additional coverages were offered. During the period in suit, ABE was the group policyholder and administrator of policies offering substantial amounts of life, disability, in-hospital indemnity, excess major medical, and accidental death and dismemberment coverage. Only members in good standing were eligible to purchase coverage under these policies. The gross premiums charged to individual insureds for these coverages are comparable to the premiums charged for similar group and individual insurance.

Under the terms of the contracts with its insurers, the amount of premiums not needed by the insurer to pay claims and administrative expenses is returned to ABE. These amounts, which ranged as high as 50% of gross premiums, were denominated either "dividends to policyholders" or "experience rating refunds" (dividends). From these dividends, the Endowment paid its own administrative and promotional expenses, which averaged 25-30% of the dividends, and used the balance to fund its grantmaking program.

As part of the contract between ABE and the insured members, individual insureds were required to sign a statement acknowledging that all dividends would be paid to and used by ABE to further its charitable and educational activities. Individual insureds could not obtain the portion of the dividend allocable to their premium payments. However, they were annually advised by ABE that, in the opinion of its counsel, they could claim a charitable contribution deduction for this amount. Four individuals who claimed this deduction under IRC 170 had their cases joined with the ABE litigation under IRC 511-513.

Administratively, and at trial, the government contended that the dividends received by ABE constituted income from the unrelated trade or business of selling insurance, and that such income was taxable under IRC 511-513. The Endowment argued that the dividends were not received from a trade or business; rather, they were received from a charitable fundraising program carried on in conjunction with the sale of insurance to members. With respect to the individuals, the Government argued they were not entitled to charitable deductions because they did not pay more than fair market value for the coverage and because, regardless of fair market value, they made the payments with the expectation of receiving commensurate economic benefits.

(2) The Court Decisions

In American Bar Endowment v. U.S., 4 Cl. Ct. 404 (1984), the Claims Court held for the Endowment on the unrelated business income issue, but for the government on the charitable contribution question. On the first issue, the court used a "competitive, commercial manner" standard from Disabled American Veterans v. United States, 650 F.2d 1178 (Ct. Cl. 1981) (DAV). The Court indicated that determining whether income was derived from the provision of goods or services, as distinguished from fundraising, depended on whether the activity was conducted in a competitive, commercial manner. The Court determined ABE's insurance program was not operated in this manner because (1) the history of the program indicated it was originally conceived as a fundraising mechanism; (2) the leadership and the membership generally viewed it as a fund-raising activity; (3) "staggering" profits were generated; (4) ABE informed its members and the public of the amount raised through the insurance program; and, (5) the program was operated with the approval and consent of the membership.

Contrary to the approach followed in DAV, the Court did not consider the significance of the price of ABE's insurance. In DAV, the Court of Claims ruled that items sold by an exempt organization for more than twice their value did not generate unrelated business income, but items sold for amounts not greatly in excess of their value did generate taxable income. The Court in ABE indicated price was not a factor in its analysis because the membership's control over the financial results of the insurance program was fundamentally inconsistent with characterization of the activity as a business.

According to the Court, the cases cited by the Government, Professional Insurance Agents v. Commissioner, Carolinas Farm & Power Equipment Dealers Association v. United States, and Louisiana Credit Union League v. United States, discussed earlier in this article, were said to be distinguishable in two respects. First, the "profit motive" standard used in these cases to define when business leagues are engaged in an enterprise taxable under IRC 511-513 is not appropriate to define trade or business for charitable organizations described in IRC 501(c)(3) because business leagues cannot receive charitable contributions. For charities the appropriate standard is the "competitive, commercial manner" standard enunciated in DAV. Second, the Court suggested the magnitude of the fees collected by the organizations and the absence of candor between them and their members (none of the cited cases indicate that members were fully informed of the arrangements with the insurance companies) were facts sufficient to distinguish these insurance programs from the Endowment's.

On the contributions issue, the Court stated plaintiffs could establish their insurance premium payments were of a dual nature, part purchase price/part charitable contribution, only if they "bought goods or services for more than their economic value, with the intention that the excess be used to benefit a charitable enterprise." This intent is negated if the entire amount paid is economically motivated. In determining whether the individual insureds paid more for the coverage than its economic value, the relevant inquiry is whether comparable group insurance was available to the insureds at a lower price. The second element, intent to benefit charity, would not be met by an insured's mere awareness that charity would receive some benefits from the payment. Rather, it required a conscious decision to pass up an economically more attractive package in order to benefit charity.

Under this two part analysis, the first three plaintiffs failed to carry their burden of showing they paid more for ABE coverage than they would have otherwise had to pay. The fourth plaintiff proved that he was eligible to purchase less expensive comparable insurance; however, he was still not entitled to a deduction because he did not prove he had knowingly passed up this more attractive insurance in order to make a contribution to ABE.

In American Bar Endowment v. U.S., 761 F.2d 1573 (Fed. Cir. 1985), the Federal Circuit affirmed the trial court's judgment for the Endowment, but reversed and remanded the cases of the four individual insureds. On the UBI issue, the court affirmed on the basis of the opinion below, stating the trial court applied the correct standard (DAV's "competitive, commercial manner" standard) and properly applied that standard to the facts of the case. The PIA, LCUL, and Carolina Farm cases were distinguished, not only for the reasons stated by the trial court, but also because ABE's compensation was received in the form of dividends assigned by the members rather than stipends paid by the insurance companies. In addition, the court further distinguished these cases by stating that services performed by the business leagues were in competition with commercial enterprises. It was concluded the Endowment's funds were not received as the result of a commercial exchange and, therefore, did not constitute profits from a trade or business.

In reversing the judgment against the four individuals, the appellate court rejected the trial court's legal standard. The appellate court felt the individual insureds could make out a prima facie case in support of their claim to a charitable deduction by swearing they purchased coverage from the Endowment in order to aid it in its charitable endeavors. The burden would then shift to the Government to

show that the transaction was "basically business oriented." The Court remanded for further proceedings consistent with this analysis.

(3) Conclusions

From the Service's standpoint, the Federal Circuit's opinion in this case uses an erroneous standard to define "trade or business" and is in direct conflict with the Fourth, Fifth, and Sixth Circuit's opinions in Carolinas Farm, LCUL, and PIA. The amounts received by these business leagues were ruled to constitute compensation for fulfilling functions and performing services not significantly distinguishable from those performed by ABE. In all four cases, the organizations performed the functions of group policyholders by controlling access to the group, selecting carriers and negotiating benefit and premium levels, and performing promotional and administrative services with respect to the policies. The distinguishing features of the ABE's program noted by the Claims Court and adopted by the Federal Circuit, particularly those distinctions based on the exemption classification of the organizations are, in the Service's view, irrelevant. Accordingly, a petition for a writ of certiorari was filed with the Supreme Court.

Because the issues are so closely related, a petition was also filed in the charitable contribution cases. A favorable decision in ABE based on a finding of profit motive would result in disallowance of the insureds' claimed deductions because if the Endowment were engaged in a trade or business, the price paid by the insureds should be considered the market price. If the insureds have not paid more than market value for the insurance, they cannot in the Service's view be entitled to an IRC 170 deduction.

The Supreme Court has agreed to hear these cases, but no decision has yet been rendered.

3. Exemption Issues Under IRC 501(c)(6)

A. Revenue Rulings

The 1981 CPE text contains an extensive discussion of exemption under IRC 501(c)(6) for organizations primarily engaged in insurance-related activities. At p. 283, two state-mandated associations of insurance companies formed to provide high risk automobile and medical malpractice insurance are analyzed. These organizations were found to be engaged in "business of a kind ordinarily carried on for profit" within the meaning of Reg. 1.501(c)(6)-1 and, therefore, did not qualify

for exemption under IRC 501(c)(6). These rulings have been published as Rev. Rul. 81-174, 81-1981-1 C.B. 335 and Rev. Rul. 175, 1981-1 C.B. 337.

B. Court Decision

In North Carolina Association of Insurance Agents, Inc. v. U.S., 737 F.2d 949 (4th Cir. 1984), the plaintiff (NCAIA) acted under North Carolina statutes as the exclusive insurance agent for the state. State agencies desiring insurance contact the North Carolina Department of Insurance for coverage of particular risks. The Department then contacts the NCAIA, which determines whether the required coverage already exists. If it does not, NCAIA arranges for coverage with one of the eighteen insurance carriers with which it has an agency contract. The carrier then quotes the cost of coverage and the NCAIA bills the purchasing state agency, sending the invoice to the Department of Insurance for approval. The Department forwards the invoice to the purchasing agent, which remits payment to the NCAIA. Finally, NCAIA remits to the carriers the premiums net of its commissions, which range from 5-25% of premiums paid, depending on the type of policy written. Although the Court of Appeals determined that NCAIA was, despite the uniqueness of its business activity, engaged in a business of a kind ordinarily carried on for profit and, therefore, was not entitled to exemption under IRC 501(c)(6) as a business league, it affirmed the District Court's alternative holding in favor of the taxpayer that certain expenditures were deductible as ordinary business expenses.

4. Provision of Group Insurance Through a 501(c)(9) Affiliate

As a result of the Service's position on group insurance, IRC 501(c)(6) organizations in some instances have organized IRC 501(c)(9) voluntary employee beneficiary associations (VEBA) affiliates to provide insurance benefits to their members.

Since the exempt purpose of a VEBA is to provide employee benefits to members, the VEBA is not subject to unrelated business taxation when these benefits are provided. However, qualification as a VEBA has its own restrictive set of standards (see the VEBA topic in this text), including the requirement that a multi-employer VEBA must be composed of persons in the same line of business in the same geographic locale.

GCM 39299 (July 20, 1984) considered whether employers who are members of an IRC 501(c)(6) organization are, solely on that basis, engaged in the

"same line of business" for purposes of Reg. 1.501(c)(9)-2(a)(1). An IRC 501(c)(6) organization comprised of employers in a whole array of industries formed a trust to provide life, health, disability, or other benefits to employees of the member-employers. The trust applied for recognition of exemption under IRC 501(c)(9) claiming that the employers, all of whom were described by Economic Division E of the Standard Industrial Classification, were in the "same line of business." The GCM notes that the preamble to the IRC 501(c)(9) regulations states the "same line of business" language was retained in the final regulations to specifically prevent the circumvention of unrelated trade or business income tax by IRC 501(c)(6) organizations and concludes that the trust's membership was too broad to be considered the "same line of business" for purposes of Reg. 1.501(c)(9)-2(a)(1). Therefore, the trust did not qualify for exemption under IRC 501(c)(9).

In some instances, however, a 501(c)(6) organization will be structured so as to enable its membership to meet the requirements of both IRC 501(c)(6) and IRC 501(c)(9). In that event, a VEBA may be a viable alternative for an organization seeking to provide insurance benefits to members.